

RAB

Memorandum

September 4, 2003

To: Blair King
Emma Karlen

From: Lamont Financial

Re: Proposed New York Visit to Rating Agencies/Bond Insurers

Stone & Youngberg, senior manager for the RDA financing, has recommended that a meeting in New York with Standard & Poor's and Fitch bond rating agencies coupled with visits to MBIA, FSA and AMBAC, bond insurers would be beneficial for the pricing of the proposed RDA debt offering. The proposed meetings would be in early October and would require two days of meetings.

Justification for New York Visit

- Due to the financial crisis in the State and the unsettling political environment, bond insurers are showing resistance for California related bond transactions. This is most apparent for tax increment credits due to the recent "takeaway" legislation proposed by the State. The Milpitas proposed bond issuance is extremely strong and the most effective way to deliver that message will be a face-to-face presentation.
- The New York visit will be to individuals, rating agencies and insurers, responsible for the approval or denial of the RDA proposed financing. A local visit (San Francisco), in the opinion of the underwriter, will not provide the forum where the RDA can best be presented and strong rebuttals given for the concerns of the parties.

Cost Implications of New York Visit

- The underwriter believes that the RDA can save as much as 5 basis points if bond insurance can be secured. This translates into an annual interest cost savings of \$100,000 per year (based on \$200 million issue). Over a 20-year bond term, the nominal savings can be close to \$2 million.
- The savings can be further enhanced if the RDA is successful in securing an underling "A" rating. The strong rating will result in the bond insurers charging less for the insurance guarantee. This could be an additional savings of \$400,000 based on a 10 basis point decline in the insurers fee.
- The expense of sending a limited number of individuals to New York will cost approximately \$9,000. We believe this number can be reduced if successful in securing discount airfares.

Based on the potential benefit to be achieved from a New York presentation, we would recommend the City seriously consider such a trip.

Tax Supported
Special Report

Caution Ahead: The Impact of California's Budget on Local Governments

Analyst

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■ Outlook

With the recent passage of California's fiscal 2004 budget, local governments appear to be spared the dramatic program reductions and revenue changes once feared. However, Fitch Ratings views the current situation as only a temporary reprieve. By the state's own acknowledgement, the current year's budget does not achieve structural balance. In fact, California's Legislative Analyst's Office projects an \$8 billion gap in the fiscal 2005 budget. Budget balancing will again be a sizable challenge for the state in fiscal 2005, when another round of significant revenue and expenditure changes will be considered.

As a result, Fitch views the future for local governmental entities as needing caution. Fiscal prudence and strong financial management argue for sustainment of much of the fiscal discipline Fitch-rated entities have exhibited to date. Budgetary reviews and adjustments will be needed and made by several entities, and pressures will mount to reverse implemented program, service level, and staff reductions. However, as discussed in several Fitch commentary pieces, fiscal integrity requires matching ongoing expenditures with ongoing revenue. Unfortunately, given the projected state budget imbalance for fiscal 2005, revenue and spending as structured under the fiscal 2004 budget cannot be viewed with any certainty as recurring.

The current circumstances facing California's cities, counties, school districts, and redevelopment agencies provide excellent proof of the importance of financial flexibility and strong fiscal management to credit quality. To date, most Fitch-rated entities have acted responsibly in formulating their fiscal 2004 budgets, conservatively projecting revenue and expenditures and developing contingency plans based on envisioned outcomes of the state's budget. While some entities reduced fund balance reserves in fiscal 2003, most kept reasonable financial cushions going into this year. This flexibility, along with prudent actions taken to date, leaves these entities better positioned to handle the current state changes and those likely to come in fiscal 2005.

This report focuses on the new budget's impact on specific municipal types, although actual results will vary by entity. The discussion is based on a preliminary and broad analysis developed from the limited information available at this time. Fitch will continue to monitor the state's budgetary developments as details are formulated and released, and Fitch will review individual entities' actions in response to the new state budget.

August 11, 2003

■ School Districts

In the fiscal 2004 budget, total state dollars allocated to school districts increases slightly over the amount received in fiscal 2003, but is below the budgeted amount for last year. However, much of the growth represents funds deferred from fiscal 2003 into the current year and increases for enrollment growth and pension fund contributions. These gains are partially offset by categorical funding cuts, with the largest reductions in instructional materials, resources for underperforming schools, deferred maintenance, and child care programs.

Per pupil funding rises to \$6,887 in the fiscal 2004 budget from the \$6,624 received in fiscal 2003, a 4.0% increase. However, the fiscal 2003 figure resulted from three reductions from the fiscal 2003 budgeted level made throughout the year. While the total amount increases, school districts, in effect, will receive very little in new funds, with most of the increase representing payments that were deferred from fiscal 2003 into the current fiscal year, revenue to meet student growth, and payments to cover increased contributions for employee pensions. Enrollment growth is funded from a 1.3% increase.

Basic aid school districts will experience a small state revenue decrease. Basic aid school districts are those with property values high enough to allow the districts to reach or exceed the per pupil funding amount solely through property taxes and, therefore, receive no state funds under this formula. The budget eliminates the \$120 per pupil payment these districts received in prior years. Initial budget discussions considered transferring these districts' property tax collections in excess of the per pupil amount to the state for redistribution to less wealthy districts. Such action likely would have been challenged in court.

Funding for categorical spending is reduced to partially offset mandatory increases for other educational expenses. Categorical programs include a wide variety of items, including books, supplies, and other instructional materials, the state's Immediate Intervention for Underperforming Schools Program, child care for low-income parents, summer school, and deferred maintenance. These programs are viewed as having a lesser impact on students than reductions in general funding.

The state budget attempts to make up for the lack of a funded cost of living increase and the categorical reductions by granting districts additional flexibility

with reserves and maintenance of effort requirements. The budget allows districts to use prior state revenue, currently held as reserves for economic uncertainty, categorical programs, and maintenance, to balance their fiscal 2004 budgets. The state budget allows each district to reduce its reserve for economic uncertainty to one-half of the prior requirement, decreasing the reserve to 0.5%–2.5% of general purpose spending, depending on the district's size. Districts are allowed to maintain this lower level in fiscal 2005 as well, and the state budget does not discuss rebuilding the reserve. Presumably, the reserve requirement will return to the prior level (1%–5% of general purpose spending) for fiscal 2006, barring further action in subsequent state budgets. Districts also are allowed to backfill general spending needs using prior years' funds received and previously restricted for categorical programs. Also, the state budget eases the requirement for district spending on general maintenance to receive state funds for this purpose.

While such measures provide budgetary relief, use of reserves is a one-time action, as the state's easing of spending requirements is not permanent. Districts should be aware that use of reserves for ongoing expenditures builds a structural imbalance into budgets. Also, it limits financial flexibility in future years that is key to maintaining credit quality in uncertain budgetary times. Although Fitch finds a very limited amount of reserve use acceptable under certain conditions, a 50% reduction is significant and will be questioned. When using reserves, district management's awareness that an imbalance is being formed or enlarged is key to minimizing credit deterioration. Also, a realistic and sound plan to address the budgetary imbalance and rebuild the reserves is essential.

■ Cities and Counties

For California cities and counties, the greatest relief in the state's fiscal 2004 budget is that no additional property tax revenue is shifted to the Educational Augmentation Revenue Fund (ERAF), to which revenues began being directed during the state's early 1990s budget crises. Rather, the impact for cities and counties is moderate, with partial offset achieved through relief from mandated expenditures. However, a key element of the state's budget package is a \$10.7 billion deficit bond issuance, which will be backed by sales tax revenue through a swap with local governments. The full impact of this shift will rest in the details, few of which are known currently. The resulting uncertainty for local governments

compounds their need to proceed cautiously when amending their fiscal 2004 budgets and planning future financing.

The state budget redirects a share of the local one-half-cent sales tax from cities and counties to the state, with this revenue pledged to the state's planned deficit bond financing. The state will match the shifted funds using property tax revenue taken from the ERAF, which currently provides revenue to school districts. The state will make up the difference to school districts from other general fund resources, meeting the budgeted per pupil funding amounts.

The sales/property tax swap will alter municipalities' cash flows, since sales taxes are remitted to local governments monthly and property taxes are collected semiannually. Cities and counties also will see reduced interest income on sales tax collections, although the loss will be relatively small. Despite this change, Fitch does not view any of its rated local government tax and revenue anticipation note (TRAN) or tax anticipation note (TAN) issues as in danger of default. Rather, all these issues rated by Fitch prudently require repayment set-asides timed to the property tax cycle, with full debt service payments restricted into dedicated accounts ahead of maturity. These actions allow ample variance in revenue receipts from the actual cash flow.

Among the fiscal 2004 budget's most significant known direct impacts for cities and counties is the lack of state backfill for the delayed increase in the statewide vehicle license fee. The fee increase is effective Oct. 1, and many local governments had assumed the state would provide the difference between the new rate and the prior rate for the three months the lower rate remains in effect. However, the state budget does not provide these funds, estimated at \$845 million statewide. Since the backfill funds had not been in prior budget versions, many municipalities have been aware of this loss. Many include the backfill funds in their fiscal 2004 budgets but prepared contingency plans in the likely event they were lost. Fitch modeled the potential loss of three months of backfill revenue into all TRAN and TAN ratings done this year, and all showed sufficient liquidity without the funds.

The state budget gives local governments some relief from expenditure mandates, particularly for programs in which state funding is deferred. While this action seems logical, state funding reductions have not always accompanied this additional expenditure

flexibility. The relief will help local entities achieve fiscal balance, as well as utilize limited resources based more on local priorities.

While the budget includes sizeable reductions in health and social service programs, these cuts are not as large as once feared by counties in particular. However, this relief is temporary given next year's projected deficit. In addition to program reductions, the budget achieves savings for the state through limiting eligibility, heightened fraud detection, and a one-time \$930 million accounting change. State reductions for social and health programs and functions present problems for counties, in that individuals needing services and care continue to seek help, often at county-run facilities. When state funding is decreased, eligibility restricted, or programs eliminated, a portion of the cost often ends up being borne unavoidably by counties. Cities are impacted as well, although less directly.

Like school districts, cities and counties will re-examine their fiscal 2004 adopted budgets, as has been the practice in most recent years. Pressure will undoubtedly be great to rebuild expenditures by restoring reduced or eliminated programs, granting salary and or benefit increases, easing hiring restrictions, and so on. However, as already mentioned, Fitch views the current budget status as uncertain, and current revenue allocation cannot be viewed as permanent. Prudent financial practices argue for conservative assumptions regarding future state funding, maintaining or rebuilding reserves, and limited budgetary expansion.

■ Redevelopment Agencies

Redevelopment agencies appear to have received the greatest fiscal relief when comparing the recently approved state budget with the governor's proposal made in January. The current budget enacts a one-time shift in tax increment revenue from redevelopment agencies to the ERAF, equaling \$250 million under the Senate version. The Assembly budget bill suggests \$135 million, with the difference to be worked out once the legislature reconvenes on Aug. 18. However, in either case, the shift is for fiscal 2004 only. In the January proposal, the recommended change was permanent and increasing over the next 15 years. While the one-time nature of this transfer may be in doubt given the state's continuing budget imbalance, a permanent change has not been made at least for the near term.

At \$250 million, the shift is 3.3 times larger than the \$75 million transferred in fiscal 2003, which may foreshadow future state action. Nonetheless, the shift comes with some flexibility for redevelopment agencies that is important for bondholders. Each redevelopment agency's required payment will be allocated in proportion to its overall tax base, with the individual agency able to determine how to distribute the transfer among project areas. The discretion given to each agency enables the entities to take revenue from project areas able to handle the loss without endangering debt repayment.

Over the longer term, if redevelopment agencies continue to see property tax revenue shifts and, especially, if the amounts rise, such action could reduce credit quality for tax allocation bonds. Also, removal of tax increment revenue from the individual project areas threatens redevelopment efforts and

could weaken overall economic credit factors. Fitch will continue to apply tax shift stress scenarios to tax allocation bond issues for which ratings are sought.

■ Future Developments

As with most broad government actions at any level, much of the true impact of the state's fiscal 2004 budget lies in the details. The impact of the new budget on local governments will become clearer only as more practical aspects are determined and disclosed. In particular, Fitch will monitor developments involving the state's proposed deficit bond financing's impact on local governments' tax revenue receipts. In the meantime, Fitch will discuss budget amendment actions with local government entities and will comment, as needed, on particular issuers and trends that may emerge.

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